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SUBJECT: CYPRUS: CENTRAL BANK GOVERNOR TAKES NEW JOB IN HIS STRIDE

REF: NICOSIA 350

(U) This cable is sensitive but unclassified. Please protect accordingly.

¶1. (SBU) Summary: The recently appointed Governor of the Central Bank of Cyprus, Athanasios Orphanides, assured us that global financial problems arising from the "sub-prime" sector shake-out is a non-issue for Cyprus. Problems he identified for Cyprus are locally sourced (an overheated property market and bank over-lending to the sector; lack of a centralized credit bureau and lack of proper financial supervision in the "TRNC" causing the island's overall reputation to suffer). He remains confident that, despite these issues, the financial sector here is sound and that the introduction of the Euro on January 1 will go smoothly. End Summary.

¶2. (U) On August 30, Econ Officer paid a courtesy call on Athanasios Orphanides, the recently-appointed (May 3, 2007) Governor of the Central Bank of Cyprus. Orphanides, as noted Reftel, is MIT-educated, and a former U.S. Federal Reserve Senior Adviser.

No Sub-Prime Problems Here

¶3. (SBU) Orphanides, like our other local interlocutors in the financial services sector, reassured us that Cyprus was not exposed to the current sub-prime loans syndrome plaguing global markets. "Cypriot banks," he noted with a grin, "are conservative and well-regulated." He also commented that Cypriot banks lack the "sophistication" to deal with "inherently riskier" products, such as Collateralized Debt Obligations (CDOs) and Structured Investment Vehicles (SIVs). On the positive side, he believes that the current problems have made the world's global financial community more properly assess and price risk. Similarly, European banks were less exposed to this problem due to their more conservative practices; where it did occur, this risk was localized - he made a pointed reference to the fact that it was not German commercial banks which have had problems but those controlled by government entities. He also addressed the "moral risk" issue of bailing out failed banks. He noted that the ECB had injected liquidity into the system, and described this as an acceptable way of dealing with the problem, as opposed to helping troubled banks individually.

Need for a Credit Bureau

¶4. (SBU) The Governor addressed the issue of credit reference services locally. Cyprus does not have a widespread culture of

using credit reference services (i.e., credit bureaus.) Credit reports on companies as well as individuals are available from a handful of financial services companies for a fee, but their operation is not institutionalized, and their client base remains rather limited. The Association of Cyprus Commercial Banks (ACC) has tried, so far without any success, to get local banks and cooperatives to set up a joint credit reference bureau. Orphanides, whose patience seemed to be running thin on this issue, commented "We will give the ACC a little more time. If the ACC cannot pull this off, then we will have to do it for them."

Property Sector Too Hot

15. (SBU) Orphanides also commented on the Central Bank's recent decision (August 17) to increase the down-payment requirement for housing loans from 30 percent to 40 percent for holiday homes and second homes and to insist that the banks adhere to the existing guideline of requiring a 20 percent down-payment for a first residence. He noted that this decision was a prudential supervisory measure, designed to cool down Cyprus' apparently overheating housing loan market. In the first five months of 2007, housing loans had increased 33.3 percent from the corresponding period in 2006, reaching CP 2.5 billion. Housing prices have also been booming in recent years, creating fears, among many, of a housing bubble. Although local banks hold all their loans in their own portfolio (there is no securitization of bank loans here) the Governor is confident that Cypriot banks will not face problems from the potential real estate bubble because they concentrate on straight housing loans, without the "exotic flavors" available in the U.S., thereby maintaining a low risk exposure to interest rate and value fluctuations with significant collateral. Nevertheless, the Central Bank wanted to let some of the air out of the overheated property sector and encourage banks to better diversify their loan portfolios away from real estate.

Euro Transition - No Problem

16. (SBU) Regarding the Euro, Orphanides seemed quite complacent that it would be adopted without a hitch on January 1, 2008. He noted that the ("largely psychological") disadvantage of Cyprus losing flexibility over determining its own monetary policy flexibility was more than counterbalanced by the benefits of adopting the Euro. Among these he listed the fact that Cyprus would become one of the players in determining the course of the Euro instead of the existing predicament of Cyprus of simply being at the mercy of the Euro. Decreased transaction costs and increased trade and services flows complete the picture of optimism that he painted.

How Do You Solve a Problem Like Supervision?

17. (SBU) He noted that Cyprus was following closely the global debate on improving financial services supervision. He said creating a single regulatory authority for all financial services, as in the case of the United Kingdom with the Financial Services Authority (FSA), was not necessarily the best model for all countries. Such an arrangement, he noted, might even pose conflict of interest issues for the single regulator, due to the different needs of the different financial services sectors. He noted that to date, the UK had not yet had the chance to test the hypothesis of how well such a regulatory model really works when a crisis hits and therefore remains unproven. On the other hand, he noted, the U.S. offered an alternative model of regulation, with its own strengths and weaknesses.

18. (U) Orphanides did not address specific weaknesses of Cyprus' current financial services supervisory model directly, although this is what he was alluding to. Cyprus currently has five supervisory bodies to supervise the different branches of its prospering financial services sectors: (a) the Central Bank of Cyprus oversees commercial banks, both foreign-owned and domestic; (b) the Cooperative Central Bank supervises cooperative credit societies, although it does report to the Central Bank of Cyprus for deposits; (c) the Cyprus Securities and Exchange Commission (SEC) supervises stock trading firms; (d) the Superintendent for Insurance Control supervises insurance companies; and (e) a new authority has been set

up recently to oversee employee provident funds. This fragmentation of supervisory responsibility, although by no means unique to Cyprus, poses its own challenges, feeding the debate of its pros and cons, both in Cyprus and abroad.

Money Is Dirtier in the North

¶9. (SBU) On money laundering, Orphanides noted that Cyprus was probably at the top of the list of countries doing everything in their power to stem the problem. He also commented that it was high time the international community addressed the money laundering problems in the north of Cyprus. He said that it was unfair for Cyprus' image abroad to suffer from wrong-doings in the area of Cyprus outside the control of the government. "Turkey should be held accountable for these problems," he stressed, "not the GOC." The Governor noted that "legally we have the obligation to supervise banks in the occupied area, but we can't fulfill this function for well-known reasons." He therefore requested Embassy assistance to learn more about USAID programs directed toward the financial sector in the north of the island.

¶10. (SBU) On September 24-25, the EU led by the UK is sponsoring a discussion in the north on anti-money laundering practices. The Central Bank has already offered to participate in this discussion but, according to Central bank officials, the Turkish Cypriots have refused to allow them to participate. Orphanides noted that the Republic of Cyprus naturally cared about what happened in its own territory and that it was unfortunate that representatives from all other EU nations would participate, without the ROC.

¶11. (SBU) Comment: Orphanides started off the meeting by proudly displaying his farewell present from the Fed: a framed set of one-dollar bills signed by all his former colleagues, including Fed Governor Bernanke. Orphanides is clearly proud of his Fed experience and appeared very confident and relaxed in his new role, speaking with authority and conviction. He clearly enjoyed talking about global financial matters even while stating that Cyprus is largely insulated from much of the current problem due to the local system's basic conservatism.

¶12. (SBU) Comment continued: The Governor clearly wants to find ways to help improve oversight and regulation in the north of Cyprus and therefore seems supportive of USAID's efforts in this regard. Such support from someone who has already gained considerable respect and support in the GOC will be helpful to US and EU efforts to ensure GOC support (or at least avoid GOC opposition to) ameliorate money laundering issues in the "TRNC."

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